

# **Sankaty Credit Opportunities, L.P.**

## **Financial Statements**

**December 31, 2009 and 2008**

**Report of Independent Auditors**

To the Partners of Sankaty Credit Opportunities, L.P.

In our opinion, the accompanying statements of assets, liabilities and partners' capital, including the condensed schedules of investments, and the related statements of operations, changes in partners' capital and of cash flows present fairly, in all material respects, the financial position of Sankaty Credit Opportunities, L.P. (the "Partnership") at December 31, 2009 and 2008, and the results of its operations, changes in its partners' capital and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the General Partner. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these financial statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by the General Partner, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

*PricewaterhouseCoopers LLP*

March 26, 2010

**Sankaty Credit Opportunities, L.P.**  
**Statements of Assets, Liabilities and Partners' Capital**  
**December 31, 2009 and 2008**

	2009	2008
<b>Assets</b>		
Investments, at fair value (cost \$294,014,947 and \$331,774,295)	\$ 201,123,830	\$ 183,026,609
Cash and cash equivalents	42,492,403	37,421,602
Restricted cash for credit default swaps	19,141,763	64,778,056
Credit default swaps, at fair value (cost \$0 and \$0)	27,814	-
Unrealized appreciation of forward currency contracts	522,529	4,662,725
Interest receivable	2,944,512	4,032,709
Other assets	142,431	82,500
<b>Total assets</b>	<b>\$ 266,395,282</b>	<b>\$ 294,004,201</b>
<b>Liabilities</b>		
Credit default swaps, at fair value (proceeds \$0 and \$0)	\$ 5,517,250	\$ 17,438,653
Unrealized depreciation of forward currency contracts	313,506	-
Due to broker - margin	896,556	3,569,254
Management fee payable	5,041	955,615
Distribution payable	28,084	-
Deferred taxes payable	269,733	42,022
Accrued expenses and other liabilities	153,700	11,052
<b>Total liabilities</b>	<b>7,183,870</b>	<b>22,016,596</b>
<b>Commitments</b>		
<b>Partners' capital</b>	<b>259,211,412</b>	<b>271,987,605</b>
<b>Total liabilities and partners' capital</b>	<b>\$ 266,395,282</b>	<b>\$ 294,004,201</b>

The accompanying notes are an integral part of these financial statements.

**Sankaty Credit Opportunities, L.P.**  
**Statements of Operations**  
**For the Years Ended December 31, 2009 and 2008**

	2009	2008
<b>Investment Income</b>		
Income:		
Interest (net of withholding taxes of \$0 and \$219,500)	\$ 17,224,331	\$ 24,836,798
Dividends and other income	1,631,107	12,951,632
<b>Total investment income</b>	<b>18,855,438</b>	<b>37,788,430</b>
Expenses:		
Management fee	3,859,616	4,651,755
Professional fees and operating expenses	1,385,883	1,266,002
Interest expense on securities sold short	2,432	107,721
<b>Total expenses</b>	<b>5,247,931</b>	<b>6,025,478</b>
<b>Net investment income</b>	<b>13,607,507</b>	<b>31,762,952</b>
<b>Net realized and unrealized gains and losses</b>		
Net realized loss on investments and securities sold short (net of withholding taxes of \$52,375 and \$0, respectively)	(23,345,470)	(375,034)
Net realized gain (loss) on foreign currency transactions	982,124	(1,285,267)
Net realized gain on forward currency contracts	1,182,507	789,805
Net realized gain (loss) on credit default swaps	(3,415,926)	6,923,369
Net change in unrealized appreciation of investments, and securities sold short (net of increase (decrease) in deferred withholding tax of \$175,336 and (\$743,425), respectively)	55,681,233	(119,099,586)
Net change in unrealized appreciation on credit default swaps	11,949,217	(16,672,857)
Net change in unrealized appreciation of forward currency contracts	(4,453,702)	7,172,526
Net change in unrealized appreciation from foreign currency translation	64,401	(670,286)
<b>Net realized and unrealized gains (losses)</b>	<b>38,644,384</b>	<b>(123,217,330)</b>
<b>Net increase (decrease) in partners' capital resulting from operations</b>	<b>\$ 52,251,891</b>	<b>\$ (91,454,378)</b>

The accompanying notes are an integral part of these financial statements.

**Sankaty Credit Opportunities, L.P.**  
**Statements of Changes in Partners' Capital**  
**For the Years Ended December 31, 2009 and 2008**

	<b>Limited Partners*</b>	<b>General Partner</b>	<b>Total</b>
<b>Balance at December 31, 2007</b>	<b>\$ 353,513,631</b>	<b>\$ 10,019,369</b>	<b>\$ 363,533,000</b>
Distributions	(91,017)	-	(91,017)
Management Fee - Net	(4,651,755)	-	(4,651,755)
Carried Interest	9,930,556	(9,930,556)	-
Allocation of net decrease in partners' capital resulting from operations (excluding management fee and carried interest)	<u>(84,531,507)</u>	<u>(2,271,116)</u>	<u>(86,802,623)</u>
<b>Balance at December 31, 2008</b>	<b>\$ 274,169,908</b>	<b>\$ (2,182,303)</b>	<b>\$ 271,987,605</b>
Distributions	(60,728,782)	(4,299,302)	(65,028,084)
Management Fee - Net	(3,859,616)	-	(3,859,616)
Carried Interest	(10,748,732)	10,748,732	-
Allocation of net decrease in partners' capital resulting from operations (excluding management fee and carried interest)	<u>55,212,695</u>	<u>898,812</u>	<u>56,111,507</u>
<b>Balance at December 31, 2009</b>	<b>\$ 254,045,473</b>	<b>\$ 5,165,939</b>	<b>\$ 259,211,412</b>

\* Included in the limited partners' capital account balance at December 31, 2009 and 2008 are \$9,354,805 and \$10,667,394, respectively, which relate to limited partners who are members of the Bain Capital Group. The Investment Advisor has waived management fees with respect to these limited partners for the year ended December 31, 2009 and 2008.

The accompanying notes are an integral part of these financial statements.

**Sankaty Credit Opportunities, L.P.**  
**Statements of Cash Flows**  
**For the Years Ended December 31, 2009 and 2008**

	2009	2008
<b>Cash provided by operating activities:</b>		
Purchases of investments	\$ (51,799,929)	\$ (120,588,430)
Payments for credit default swaps	(9,297,832)	(842,104)
Purchases of covers of securities sold short	(126,839)	(207,692)
Proceeds from sales of investments	19,929,016	53,630,397
Proceeds from credit default swaps	5,881,906	7,610,562
Proceeds from sales of securities sold short	91,576	11,855
Proceeds from principal paydowns of investments	57,598,780	64,251,101
	<u>22,276,678</u>	<u>3,865,689</u>
<b>Net effects from foreign currency translation</b>	2,229,032	(1,165,748)
<b>Net investment income</b>	13,607,507	31,762,952
<b>Adjustments to reconcile net investment income to net cash used for operating activities:</b>		
Non-cash interest and dividend income	(11,454,062)	(14,437,131)
(Increase) decrease in restricted cash	45,636,293	(5,326,175)
Decrease in interest and dividends receivable	1,088,197	759,024
Increase in other asset	(59,931)	(73,102)
Increase (decrease) in deferred tax payable	227,711	(743,425)
Increase (decrease) in management fee payable	(950,574)	955,615
Increase (decrease) in accrued expenses and other liabilities	142,648	(183,853)
	<u>72,743,499</u>	<u>15,413,846</u>
<b>Net cash provided by operating activities</b>		
<b>Cash (used for) provided by financing activities:</b>		
Partners' capital distributions	(65,000,000)	(91,017)
Increase (decrease) in Due to broker - margin	(2,672,698)	3,569,254
	<u>(67,672,698)</u>	<u>3,478,237</u>
<b>Net cash (used for) provided by financing activities</b>		
	<u>5,070,801</u>	<u>18,892,083</u>
<b>Net increase in cash and cash equivalents</b>		
	<u>37,421,602</u>	<u>18,529,519</u>
<b>Cash and cash equivalents, beginning of year</b>		
	<u>\$ 42,492,403</u>	<u>\$ 37,421,602</u>
<b>Cash and cash equivalents, end of year</b>		
	<u>\$ 42,492,403</u>	<u>\$ 37,421,602</u>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	\$ 2,432	\$ 107,721
Cash paid for taxes	\$ -	\$ 219,500

The accompanying notes are an integral part of these financial statements.

**Sankaty Credit Opportunities, L.P.**  
**Condensed Schedule of Investments**  
**December 31, 2009**

<b>Investments 77.6%*</b>	<b>Fair Value</b>
<b>Corporate Fixed Income 3.2%*</b>	
Beverage and Tobacco	\$ 135,750
Broadcast Radio and Television	780
Electronic/Electric	7,486,010
Retailers (other than food/drug)	793,212
<b>Total Corporate Fixed Income (Cost \$11,827,438)</b>	<b>8,415,752</b>
<b>Senior Bank Debt 12.5%*</b>	
Aerospace and Defense	946,713
Cable Television	4,716,323
Chemical/Plastics	3,352,825
Equipment Leasing	1,545,889
Leisure (1)	16,650,888
Telecommunications/Cellular communications	5,191,348
<b>Total Senior Bank Debt (Cost \$36,617,317)</b>	<b>32,403,986</b>
<b>Mezzanine 30.3%*</b>	
Automotive	9,972,921
Business Equipment and Services	8,489,811
Conglomerates (2)	14,174,237
Financial Intermediaries	6,442,123
Food Products (3)	13,561,473
Healthcare	8,468,236
Leisure	7,814,787
Oil and Gas	457,600
Retailers (other than food/drug)	2,120,392
Surface Transportation	7,102,116
<b>Total Mezzanine (Cost \$88,363,687)</b>	<b>78,603,696</b>
<b>Common Stock 17.4%*</b>	
Automotive	1,508
Beverage and Tobacco	546,007
Business Equipment and Services	144,192
Electronic/Electric	10,386,623
Financial Intermediaries	139,864
Food Products (4)	17,605,869
Healthcare	140,571
Insurance	5,694,200
Leisure	290,193

The accompanying notes are an integral part of these financial statements.

**Sankaty Credit Opportunities, L.P.**  
**Condensed Schedule of Investments**  
**December 31, 2009**

<b>Investments (continued)</b>	<b>Fair Value</b>
Oil and Gas	\$ 7,461,886
Retailers (other than food/drug)	1,953,542
Surface Transportation	741,600
<b>Total Common Stock Investments (Cost \$73,502,151)</b>	<b>45,106,055</b>
<b>Preferred Stock 3.4%*</b>	
Business Equipment and Services	208,780
Electronic/Electric	3,000,374
Food Products	3,953,794
Healthcare	443,895
Retailers (other than food/drug)	1,003,638
Surface Transportation	133,000
<b>Total Preferred Stock Investments (Cost \$13,001,432)</b>	<b>8,743,481</b>
<b>Warrants 0.3%*</b>	
Business Equipment and Services	766,979
Food Products	25
<b>Total Warrant Investments (Cost \$890,800)</b>	<b>767,004</b>
<b>Structured Investments 10.4%*</b>	
Financial Intermediaries	23,390
Structured Finance Obligation	27,060,466
<b>Total Structured Investments (Cost \$69,812,122)</b>	<b>27,083,856</b>
<b>Total Investments (Cost \$294,014,947)</b>	<b>\$ 201,123,830</b>
<b>Credit Default Swaps -2.1%*</b>	
<b>Providing Protection -2.1%*</b>	
Chemical/Plastics	(111,961)
Retailers (other than food/drug)	6,345
Structured Finance Obligation	(5,383,820)
<b>Total Providing Protection (Cost \$0)</b>	<b>(5,489,436)</b>
<b>Total Credit Default Swaps (Cost \$0)</b>	<b>\$ (5,489,436)</b>

The accompanying notes are an integral part of these financial statements.



**Sankaty Credit Opportunities, L.P.**  
**Condensed Schedule of Investments**  
**December 31, 2009**

<b>Investments (continued)</b>	<b>Fair Value</b>
<b>Forward Contracts 0.1%*</b>	
Pounds Sterling/USD	\$ 284,432
Euro/USD	(276,430)
Canadian Dollar/USD	201,021
<b>Total Forward Contracts (Cost \$0)</b>	<b>\$ 209,023</b>
The geographical categorization by country of issuer of the value of investments is as follows:	
USA	93.9%
Germany	2.3%
Netherlands	3.7%
	100.0%
At December 31, 2009, the country of issuer of the credit default swaps providing protection were as follows:	
USA	97.6%
United Kingdom	2.4%
	100.0%

\*All investment category percentages are calculated as a percentage of total partners' capital of \$259,211,412.

- (1) Sankaty LuxCo S.à.r.l. Manchester United - PIK Loan, fair value of \$16,650,888 represents 6.4% of partners' capital of the Partnership.
- (2) Continental Cement Company LLC, fair value of \$14,174,237 represents 5.5% of partners' capital of the Partnership.
- (3) Harvest Time Bread Company, fair value of \$14,062,619 represents 5.4% of partners' capital of the Partnership.
- (4) Mountain City Meat Co., Inc. fair value of \$17,897,576 represents 6.9% of partners' capital of the Partnership.

The accompanying notes are an integral part of these financial statements.

**Sankaty Credit Opportunities, L.P.**  
**Condensed Schedule of Investments**  
**December 31, 2008**

<b>Investments 67.3%*</b>	<b>Fair Value</b>
<b>Corporate Fixed Income 4.0%*</b>	
Beverage and Tobacco	\$ 1,086,000
Broadcast Radio and Television	311,969
Electronic/Electric	5,355,268
Food Services	3,875,481
Publishing	349,091
<b>Total Corporate Fixed Income (Cost \$21,619,178)</b>	<b>10,977,809</b>
<b>Senior Bank Debt 11.0%*</b>	
Acrospace and Defense	561,311
Cable Television	2,065,690
Chemical/Plastics	6,633,806
Equipment Leasing	941,441
Financial Intermediaries	7,183,703
Nonferrous Metals/Minerals	6,116,588
Telecommunications/Cellular communications	6,454,935
<b>Total Senior Bank Debt (Cost \$50,960,753)</b>	<b>29,957,474</b>
<b>Mezzanine 26.2%*</b>	
Automotive	9,801,413
Business Equipment and Services	11,360,201
Conglomerates	12,154,310
Financial Intermediaries	4,181,008
Food Products	15,423,835
Healthcare	7,250,753
Leisure	1,537,615
Oil and Gas	430,320
Retailers (other than food/drug)	3,971,735
Surface Transportation	5,147,657
<b>Total Mezzanine (Cost \$86,215,342)</b>	<b>71,258,847</b>
<b>Common Stock 15.3%*</b>	
Air Transportation	370,384
Building and Development	613,273
Business Equipment and Services	9,399
Electronic/Electric	5,682,408
Financial Intermediaries	84,994
Food Products**	17,588,536

The accompanying notes are an integral part of these financial statements.

**Sankaty Credit Opportunities, L.P.**  
**Condensed Schedule of Investments**  
**December 31, 2008**

<b>Investments (continued)</b>	<b>Fair Value</b>
Insurance	\$ 4,812,000
Leisure	3,588,435
Oil and Gas	8,036,139
Surface Transportation	360,000
Telecommunications/Cellular communications	444,812
<b>Total Common Stock Investments (Cost \$93,670,364)</b>	<b>41,590,380</b>
<b>Preferred Stock 3.5%*</b>	
Automotive	1,691
Business Equipment and Services	206,881
Electronic/Electric	4,543,486
Food Products	3,752,640
Healthcare	453,142
Retailers (other than food/drug)	411,721
Surface Transportation	133,000
<b>Total Preferred Stock Investments (Cost \$12,666,503)</b>	<b>9,502,561</b>
<b>Warrants 0.2%*</b>	
Business Equipment and Services	460,331
Food Products	6,756
<b>Total Warrant Investments (Cost \$890,800)</b>	<b>467,087</b>
<b>Structured Investments 6.1%*</b>	
Structured Finance Obligation	16,597,372
<b>Total Structured Investments (Cost \$64,574,408)</b>	<b>16,597,372</b>
<b>Options 1.0%*</b>	
Oil and Gas	\$ 2,675,079
<b>Total Option Investments (Cost \$1,176,947)</b>	<b>2,675,079</b>
<b>Total Investments (Cost \$331,774,295)</b>	<b>\$ 183,026,609</b>

The accompanying notes are an integral part of these financial statements.

**Sankaty Credit Opportunities, L.P.**  
**Condensed Schedule of Investments**  
**December 31, 2008**

Investments (continued)	Fair Value
<b>Credit Default Swaps -6.4%*</b>	
<b>Providing Protection -6.4%*</b>	
Automotive	\$ (291,857)
Broadcast Radio and Television	(326,691)
Chemical/Plastics	(5,246,950)
Financial Intermediaries	(428,747)
Retailers (other than food/drug)	(3,758)
Structured Finance Obligation	(11,140,650)
<b>Total Providing Protection (Proceeds \$0)</b>	<b>(17,438,653)</b>
<b>Total Credit Default Swaps (Cost \$0)</b>	<b>\$ (17,438,653)</b>
<b>Forward Contracts 1.7%*</b>	
Pounds Sterling/USD	3,601,267
Euro/USD	(365,654)
Canadian Dollar/USD	1,427,112
<b>Total Forward Contracts (Cost \$0)</b>	<b>\$ 4,662,725</b>
The geographical categorization by country of issuer of the value of investments is as follows:	
USA	91.0%
United Kingdom	3.9%
Luxembourg	2.5%
Netherlands	1.2%
Other	1.4%
	<b>100.0%</b>
At December 31, 2008, the country of issuer of the credit default swaps providing protection were as follows:	
USA	92.6%
United Kingdom	7.4%
	<b>100.0%</b>

\*All investment category percentages are calculated as a percentage of total partners' capital of \$271,987,605.

\*\*Mountain City Meat Co., Inc. fair value of \$16,978,881 represents 6.2% of Net Assets of the Partnership.

The accompanying notes are an integral part of these financial statements.

# **Sankaty Credit Opportunities, L.P.**

## **Notes to Financial Statements**

### **December 31, 2009 and 2008**

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#### **1. Organization**

Sankaty Credit Opportunities, L.P. (the "Partnership") is a Delaware limited partnership, which commenced operations on August 12, 2002. Sankaty Advisors, LLC, a Delaware limited liability company and the credit affiliate of Bain Capital, LLC, serves as the investment advisor of the Partnership (the "Investment Advisor"). Sankaty Credit Opportunities Investors, LLC, a Delaware limited liability company and an affiliate of the Investment Advisor, serves as the General Partner of the Partnership (the "General Partner").

The investment objective of the Partnership is to provide superior risk-adjusted returns to the limited partnership interests by opportunistically investing in distressed/stressed debt and bank loans, mezzanine investments, structured products and special situations. The Partnership's aggregate committed capital for investments is \$500 million, of which all had been funded as of December 31, 2009 and 2008. At December 31, 2009 and 2008, the General Partner held \$5 million, or 1% of the aggregate commitments of all partners. The Partnership will continue until August 12, 2010, unless at some earlier date the Partnership ceases to have a general partner or all partners consent in writing to the termination of the Partnership or the General Partner elects to extend the life of the Partnership, which the General Partner intends to do.

The Bank of New York Mellon Trust Company and Brown Brothers Harriman serves as the Partnership's custodian. J.P.Morgan and Goldman Sachs and Co. act as custodians for the Partnership's corporate fixed income and public equity securities under prime brokerage agreements.

In addition to direct commitments, Sankaty Credit Opportunities (Offshore) I, Ltd., Sankaty Credit Opportunities (Offshore) I, L.P., and Sankaty Credit Opportunities (Offshore Plan Assets) I, L.P. were established to acquire interests in the Partnership. At December 31, 2009, Sankaty Credit Opportunities (Offshore) I, Ltd., Sankaty Credit Opportunities (Offshore) I, L.P., and Sankaty Credit Opportunities (Offshore Plan Assets) I, L.P., owned 5.9%, 50.9%, and 6.3% of partners' capital, respectively. At December 31, 2008, Sankaty Credit Opportunities (Offshore) I, Ltd., Sankaty Credit Opportunities (Offshore) I, L.P., and Sankaty Credit Opportunities (Offshore Plan Assets) I, L.P., owned 6.1%, 52.2%, and 6.5% of partners' capital, respectively.

#### **2. Significant Accounting Policies**

These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Actual results could differ from those estimates, and such differences could be material. Events or transactions occurring after period end through the date that the financial statements were issued, March 26, 2010, have been evaluated in the preparation of the financial statements.

##### **Valuation of Investments, Credit Default Swaps and Securities Sold Short**

The Investment Advisor, in consultation with the General Partner, fair values the investments owned by the Partnership. Corporate fixed income securities are generally fair valued based on the "high bid average" price obtained from an independent pricing service. Senior bank debt securities are generally fair valued based on the "mean of mean" price obtained from a loan pricing service. Public equities are generally fair valued based on the closing price listed on a United States securities exchange or, if unavailable, at the last bid price for long positions and last ask price for short positions. Swap contracts and other derivatives are fair valued as described below. For additional info related to derivative instruments utilized, please see the following footnotes: 2, 3, 4, 5 and 6.

Investments that cannot be valued, as described above, (primarily mezzanine investments, structured investments and special situations) are valued at fair value as determined in good faith by the General Partner. In determining the fair value of an investment, the General Partner considers such factors as financial statements, earnings forecasts, recent transactions in the same or similar securities and valuation

# **Sankaty Credit Opportunities, L.P.**

## **Notes to Financial Statements**

### **December 31, 2009 and 2008**

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information obtained from broker-dealers, recognized quotation services or independent appraisal firms. The fair value assigned to these investments is based upon available information and does not necessarily represent the amount that might ultimately be realized upon sale. Equity investments in structured financing vehicles (such as CLOs) are valued by the General Partner using a model that utilizes inputs determined by the General Partner to discount present value of future cash flows from the investment. The General Partner determines the fair value of certain securities, including certain structured investments, held by the Partnership on the basis of prices provided by principal market makers. Due to the inherent uncertainty of valuation, this estimated fair value may differ from the value that would have been used had a ready market for the security existed, and the difference could be material. Investments in Limited Partnerships are valued as the Partnership's proportionate investment in the net assets of the limited partnership at fair value.

The definition of "fair value" for the purposes of accounting principles generally accepted in the United States of America can and will differ from that used within the covenants of the Partnership's debt financing commitments.

#### **Cash and Cash Equivalents**

Cash includes cash held at retail banks, custodial banks and prime brokers. Included in cash and cash equivalents at December 31, 2009 and 2008 are \$37,987,815 and \$35,326,585, respectively, invested overnight in two highly liquid money market investment vehicles. As of December 31, 2009 and 2008, the vehicles were bearing interest at 0.01% and from 1.37% to 1.64%, respectively. Cash balances are presented gross of amounts due to retail banks, custodial banks, and prime brokers.

#### **Due to Broker - Margin**

Due to broker - margin represents short term margin debt balances held at various brokers.

#### **Restricted Cash**

Restricted cash for collateral held for credit default swaps represents cash collateral maintained in accounts by the respective swap agreement counterparties. Restricted cash for securities sold short represents funds maintained in interest bearing cash accounts with the custodian(s) or broker(s). Such funds are restricted from withdrawal to the extent of the value of the outstanding short sales shown on the Statements of Assets, Liabilities and Partners' Capital.

#### **Investment Transactions, Investment Income and Expenses**

Investment transactions are accounted for on the trade date. Realized gains and losses on investment transactions are determined using the specific identification method. Interest income is recorded on the accrual basis. Expenses are recorded on the accrual basis. Premiums and discounts on securities purchased and securities sold short are amortized, using the effective yield method, over the life of the respective security when cash collection is expected and included in interest income (long investments) and interest expense (short investments). Discounts on securities with fair value below 50% of par are not amortized. Certain fees received or paid on bank loans are recorded as a cost basis adjustment or as income. Dividend income is recorded on the ex-dividend date net of withholding taxes. Distributions from collateralized debt obligations are recorded as dividend income on the Statements of Operations during the collateralized debt obligation's reinvestment period. Subsequent to this reinvestment period, distributions are recorded as a return of capital. Dividend and interest income paid in the form of additional shares or par value is recorded at current fair value. For the Partnership's investments in revolving bank loans, the cost basis of the investments purchased are adjusted for the cash received for the discount on the total balance committed. The fair value is also adjusted for price appreciation or depreciation on the unfunded portion. As a result, the purchase of commitments not completely funded may result in a negative fair value until it is offset by the future amounts called and funded.

In some cases, the Partnership invests in securities indirectly through one or more holding companies or other entities in which other parties affiliated with the Partnership and/or the Investment Advisor may also be investors. In cases where the Partnership invests directly through such an entity, the Condensed Schedule of Investments reflects the Partnership's proportionate share of the underlying investment.



# **Sankaty Credit Opportunities, L.P.**

## **Notes to Financial Statements**

### **December 31, 2009 and 2008**

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#### **Restricted Securities**

The Partnership is permitted to invest in securities that are subject to legal or contractual restrictions on resale. These securities generally may be resold in transactions exempt from registration or to the public if the securities are registered. Disposal of these securities may involve time-consuming negotiations and expense, and prompt sale at an acceptable price may be difficult. At December 31, 2009 and 2008, the fair value of restricted securities (excluding 144A issues) amounted to \$21,118,507 and \$59,103,508, respectively.

#### **Income Taxes**

As a partnership, the Partnership itself is not subject to U.S. Federal income taxes. Each partner is individually liable for income taxes, if any, on its share of the Partnership's net taxable income. Interest, dividends and other income realized by the Partnership from non-US sources and capital gains realized on the sale of securities of non-U.S. issuers may be subject to withholdings and other taxes levied by the jurisdiction in which the income is sourced. As of December 31, 2009 and 2008, \$269,733 and \$42,022, respectively, was the estimated payable relating to deferred taxes and is included in Deferred taxes payable on the Statements of Assets, Liabilities and Partners' Capital.

For foreign partners invested in the Partnership, a reduction in capital could be made for withholding taxes (30% or lower treaty rate) on their allocable share of dividends as well as certain interest and other income received by the Partnership from sources within the United States.

On January 1, 2009, the Partnership adopted an accounting standard which required the Investment Advisors to determine whether tax positions of the Partnership are more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. For tax positions meeting the more likely than not threshold, the tax amount recognized in the financial statements is reduced by the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement with the relevant taxing authority. The Investment Advisors has determined that there were no tax positions which met the recognition and measurement requirements of the accounting standard, and therefore, the Partnership did not record an expense related to uncertain positions on the Partnership's Statements of Operations for the year ended December 31, 2009.

The Partnership files tax returns as prescribed by the tax laws of the jurisdictions in which it operates. In the normal course of business, the Partnership is subject to examination by federal, state, local and foreign jurisdictions, where applicable. As of December 31, 2009, the tax years that remain subject to examination by the major tax jurisdictions under the statute of limitations is from the year 2006 forward (with limited exceptions).

#### **Securities Sold Short**

Upon selling a security short, the Partnership recognizes the proceeds received as restricted cash in the Statements of Assets, Liabilities and Partners' Capital and securities sold short is established as an offsetting liability. The cash is retained by the Partnership's prime broker(s) as collateral for the short position. The liability is marked-to-market while the position remains open to reflect the current settlement obligation and the amount of collateral is adjusted accordingly. When a closing purchase is entered into by the Partnership offsetting the security sold short, a gain or loss is realized based on the difference between the proceeds originally received and the purchase cost.

A short sale creates a risk of a theoretically unlimited loss, in that the price of the underlying security could theoretically increase without limit thus increasing the cost to the Partnership of buying those securities necessary to cover a short position. There can be no assurance that the security necessary to cover a short position will be available for purchase. Purchasing securities to close out the short position can itself cause the price of the securities to rise further, thereby exacerbating the loss. As a result, short sales create risk that the Partnership's ultimate obligation to satisfy the delivery requirements may exceed the amount of the

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## **Notes to Financial Statements**

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proceeds initially received or the liability recorded in the Statements of Assets and Liabilities and Partners' Capital.

#### **Foreign Currency Translation**

The accounting records of the Partnership are maintained in U.S. dollars. The fair values of foreign securities, currency holdings and other assets and liabilities are translated to U.S. dollars based on the current exchange rates each business day. Income and expenses denominated in foreign currencies are translated at current exchange rates when accrued or incurred. Unrealized gains and losses on foreign currency holdings and non-investment assets and liabilities attributable to the change in exchange rates are included in the net increase in unrealized appreciation from foreign currency translation in the Statements of Operations. Net realized gains and losses attributable to changes in exchange rates on foreign currency holdings and non-investment assets and liabilities are included in net realized loss on foreign currency transactions in the Statements of Operations.

The portion of both realized and unrealized gains and losses on investments, credit default swaps, securities sold short and swap contracts that result from fluctuations in foreign currency exchange rates is not separately disclosed, but is included in net realized and unrealized gains on investments, credit default swaps and securities sold short in the Statements of Operations.

#### **Forward Currency Contracts**

The Partnership enters into forward currency contracts in connection with settling planned purchases or sales of securities or to hedge the currency exposure associated with the Partnership's investments. A forward currency contract is an agreement between two parties to buy and sell a currency at a set price on a future date. Forward currency contracts are fair valued daily and the change in value is recorded as an unrealized gain or loss. Forward currency contracts are valued at the prevailing forward exchange rate of the underlying currencies. Realized gains and losses equal to the difference between the fair value of the contract at the time it was opened and the fair value at the time it was closed are recorded upon delivery or receipt of the currency or, if a forward currency contract is offset by entering into another forward currency contract with the same broker, upon settlement of the net gain or loss. These contracts may involve market risk in excess of the unrealized gain or loss reflected in the Partnership's Statements of Assets, Liabilities and Partners' Capital. The Partnership may be exposed to risk if the counterparties are unable to meet the terms of the contract or if there are movements in foreign currency values that are unfavorable to the Partnership.

Unrealized gains and losses relating to the Partnership's forward currency contracts are recorded on the Statements of Assets, Liabilities and Partners' Capital by type on a net basis. On the Condensed Schedules of Investments, derivatives contracts are presented net by type of derivative contract, considering long and short contracts separately.

#### **Credit Default Swaps**

The Partnership uses credit default swaps to provide a measure of protection against defaults of corporate issuers (i.e., to reduce risk where the Partnership owns or has exposure to the issuer) or to take an active long or short position with respect to the likelihood of a particular issuer's default. The reference obligation of the swap can be a single issuer, a "basket" of issuers, or an index. The underlying reference assets are corporate debt or loans. Under the terms of each transaction, the Partnership receives or makes payments quarterly based on a specified interest rate on a fixed notional amount. Net interest earned on swaps and realized gains or losses from closing out transactions is included in net realized gain (loss) on credit default swaps in the Statements of Operations.

Generally, a credit event for corporate reference obligations means bankruptcy, failure to pay, obligation acceleration, repudiation/moratorium or restructuring. If a credit event occurs, the seller typically must pay the contingent payment to the buyer, which is typically the par value of the reference obligation, though the actual payment may be mitigated by netting arrangements and collateral. After a credit event occurs, this



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amount may be reduced by anticipated recovery rates, segregated collateral and netting arrangements that may incorporate multiple transactions with a given counterparty. The contingent payment may be a cash settlement or a physical delivery of the reference obligation in return for payment of the face amount of the obligation. The Partnership closes out transactions by entering into offsetting transactions. When transactions are closed out, a realized gain is recognized. In connection with these agreements, cash or securities are posted as collateral with the counterparty which is included in Restricted cash for credit default swaps on the Statements of Assets, Liabilities and Partners' Capital.

The Partnership values credit default swaps based on quotes obtained from a third party pricing service. When a fair value is unavailable as described above fair values are determined in good faith by the General Partner. Entering into these agreements involves, to varying degrees, elements of credit, legal, market, and documentation risk in excess of the amounts recognized on the Statements of Assets, Liabilities and Partners' Capital. Such risks involve the possibility that there will be no liquid market for these agreements, and that the counterparty to the agreements may default on its obligation to perform or disagree as to the meaning of the contractual terms in the agreements.

The Partnership may from time to time enter into various managed tranche credit default swap transactions ("Swap Transactions") whereby the Partnership contributes a net amount to financial intermediaries and provides protection, in aggregate, on pools of underlying reference assets. The net amount contributed consists of a gross amount paid upfront by the Partnership for potential credit events and a gross amount of upfront interest received by the Partnership for certain tranches of these pools. As of December 31, 2009, the Partnership holds six Swap Transactions on three pools of credit default swaps, of various credit quality, with a total notional amount of \$55,136,418. As of December 31, 2008, the Partnership held nine Swap Transactions on five pools of credit default swaps, of various credit quality, with a notional amount of \$83,765,000.

Upfront amounts received or paid are recorded as credit default swap proceeds or cost, respectively, and accreted over the life of the respective swap contracts and are included in net realized gain on swap contracts in the Statements of Operations. Unrealized gains and losses relating to the Partnership's swap contracts are recorded on the Statements of Assets, Liabilities and Partner's Capital on a gross basis. On the Condensed Schedules of Investments, derivative contracts are presented net by type of derivative contract, considering long and short contracts separately.

As of December 31, 2009 and 2008, the Partnership is the seller ("providing protection") on a total notional amount of \$64,386,418 and \$103,475,000, respectively. The notional amount of the swaps are not recorded in the financial statements; however the notional amount does approximate the maximum potential amount of future payments that the Partnership could be required to make if the Partnership was the seller of protection and a credit event was to occur.

Those credit default swaps for which the Partnership is providing protection at December 31, 2009 are summarized as follows:

Written Credit Derivative Contracts	Single Name Credit Default Swap (in thousands)		Credit Default Swap Basket (in thousands)		Total
	Debt	Loan	Debt	Loan	
Fair value of written credit derivatives	\$ (106)	\$ -	\$ -	\$ (5,384)	\$ (5,490)
Maximum potential amount of future payments	9,250	-	29,190	25,946	64,386
Collateral held by the Partnership or other third parties which the Partnership can obtain upon occurrence of triggering event	858	-	3,675	13,011	17,544

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Maximum Potential Amount of Future Payments by Contract Term (in thousands)						
Current credit rating on underlying securities	0-6 months	6-12 months	1-5 years	5-10 years	More than 10 years	Total
Investment Grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Non-Investment Grade	8,250	-	1,000	-	-	9,250
Swap Transactions	29,190	1,530	24,416	-	-	55,136
<b>Total</b>	<b>\$ 37,440</b>	<b>\$ 1,530</b>	<b>\$ 25,416</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 64,386</b>

Those credit default swaps for which the Partnership is providing protection at December 31, 2008 are summarized as follows:

Written Credit Derivative Contracts	Single Name Credit Default Swap (in thousands)		Credit Default Swap Basket (in thousands)		Total
	Debt	Loan	Debt	Loan	
Fair value of written credit derivatives	\$ (5,971)	\$ (327)	\$ -	\$ (11,141)	\$ (17,439)
Maximum potential amount of future payments	19,300	500	53,645	30,030	103,475
Collateral held by the Partnership or other third parties which the Partnership can obtain upon occurrence of triggering event	5,457	42	21,802	29,296	56,597

Maximum Potential Amount of Future Payments by Contract Term (in thousands)						
Current credit rating on underlying securities	0-6 months	6-12 months	1-5 years	5-10 years	More than 10 years	Total
Investment Grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Non-Investment Grade	-	1,550	18,250	-	-	19,800
Swap Transactions	4,455	20,000	59,220	-	-	83,675
<b>Total</b>	<b>\$ 4,455</b>	<b>\$ 21,550</b>	<b>\$ 77,470</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 103,475</b>

The credit rating disclosed above for each reference obligation where the Partnership is the seller of protection is a representation of the current payment/performance risk of the swap. Reference obligations with a credit rating of BBB or higher are considered Investment Grade while those with a credit rating of BB or lower are Non-Investment Grade. Swap Transactions are not rated by ratings agencies; however, the current credit ratings on the underlying pools of credit default swaps are predominately non-investment grade.

In some cases, the Partnership has purchased related credit protection with respect to the underlying securities where it has previously sold credit protection, thereby limiting its exposure. In these instances, the extent of recourse is difficult to estimate and therefore not disclosed.

**Option Contracts**

The Partnership buys call options and put options. The Partnership pays a premium for purchased options which are included in Cost of Investments on the Statements of Assets, Liabilities and Partners' Capital. Premiums paid for purchased options which expire are treated as realized losses. Premiums paid for purchased options which are exercised or closed are offset against the proceeds from that transaction and

# **Sankaty Credit Opportunities, L.P.**

## **Notes to Financial Statements**

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included in realized gain or loss. Option contracts are fair valued daily using a third party valuation service and the change in value is recorded as an unrealized gain or loss.

Unrealized gains and losses relating to the Partnership's derivative contracts are recorded on the Statement of Assets, Liabilities and Partners' Capital by type on a gross basis. On the Condensed Schedule of Investments, derivatives contracts are presented net by type of derivative contract, considering long and short contracts separately.

### **3. Recent Accounting Pronouncements**

#### **FASB Accounting Standards Codification™ ASC 105-10**

In June 2009, the FASB issued FASB ASC 105-10, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles*, (formerly SFAS 168). FASB ASC 105-10 replaces the SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles*, and establishes the FASB Accounting Standards Codification ("Codification") as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with GAAP. The Codification became the exclusive authoritative reference at September 30, 2009. Updates to the Codification Standards are issued as Accounting Standard Updates ("ASU"s) by the FASB. The adoption of the Codification does not impact the Partnership's financial statements except for references made to authoritative accounting literature in the footnotes.

#### **FASB Accounting Standards Codification™ ASC 815-10-50**

The Partnership adopted amendments to authoritative guidance on disclosures about derivative instruments and hedging activities on January 1, 2009. The new requirement amends and expands the disclosure requirement related to derivative instruments, to provide users of financial statements with an enhanced understanding of the use of derivative instruments by the Partnership and how these derivatives affect the financial position, financial performance and cash flows of the Partnership. This Statement requires qualitative disclosures about the objectives and strategies for using derivative instruments, quantitative disclosures about the fair value of, and gains and losses on, derivative instruments.

The standard enhances the disclosure requirements for derivative instruments and related hedging activities and thus, the adoption of the standard had no impact on the Statements of Assets, Liabilities and Partners' Capital, Statements of Operations or the Statements of Changes in Partners' Capital. The Partnership does not designate any derivative instruments as hedging instruments under the authoritative guidance.

The Partnership transacts in a variety of derivative instruments including, forwards, swaps and options primarily for trading purposes with each instrument's primary risk exposure being interest rate, credit, foreign exchange or equity risk. The fair value of these derivative instruments is included either as a separate line item in the case of purchased options or within the Investments line item, in the Statements of Assets, Liabilities and Partners' Capital with changes in fair value reflected as realized gains (losses) or net change in unrealized gains (losses) or net change in unrealized gains (losses) on credit default swap contracts, investments and securities sold short, or forward currency contracts within the Statements of Operations.

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## Notes to Financial Statements

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The following table lists fair value of derivatives by contract type as included in the Statement of Assets, Liabilities and Partners' Capital.

The total notional or contractual amounts and fair values for derivatives were:

<i>(Dollars in thousands)</i>	Notional/ contractual amount	Gross Derivative Assets (at fair value)	Gross Derivative Liabilities (at fair value)
Forward currency contracts	(26,501)	661	(453)
Credit Default Swaps	64,386	28	(5,517)
Total	\$ 37,885	\$ 689	\$ (5,970)
Netting (see note below) *		(139)	139
Carrying value of derivatives on the Statements of Assets, Liabilities and Partners' Capital		\$ 550	\$ (5,831)

*\*Note: GAAP permits the netting of derivative assets and liabilities and the related cash collateral received and paid when a legally enforceable master netting agreement exists between the Partnership and a derivative counterparty.*

During the year ended December 31, 2009, the average notional exposure on forward currency contracts, credit default swaps and purchased options were (\$29,958,656), \$81,999,234 and \$549,242, respectively.

The following table indicates the gains and losses on derivatives, by contract type, as included in the Statements of Operations for the year ended December 31, 2009.

The gains (losses) recognized in the statement of operations related to derivatives were:	
<i>(Dollars in thousands)</i>	For the year ended December 31, 2009
Forward currency contracts	(3,271)
Credit Default Swaps	8,533
Purchased Options	(1,049)
Total	\$ 4,213

The above gains (losses) on derivatives have been recognized as realized or change in unrealized on the Statement of Operations.



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The significant accounting policies relating to recording of derivatives and related gain/(loss) have been summarized in Note 2 of the financial statements.

By using derivative instruments, the Partnership is exposed to the counterparty's credit risk - the risk that derivative counterparties may not perform in accordance with the contractual provisions offset by the value of any collateral received. The Partnership's exposure to credit risk associated with counterparty non-performance is limited to collateral posted and the unrealized gains inherent in such transactions that are recognized in the Statements of Assets, Liabilities and Partners' Capital. The Partnership may minimize counterparty credit risk through, credit monitoring procedures, executing master netting arrangements and managing margin and collateral requirements, as appropriate. The Partnership records counterparty credit risk valuation adjustments, if material, on certain derivative assets in order to appropriately reflect the credit quality of the counterparty.

#### **4. Fair Value Measurements**

In accordance with authoritative guidance on fair value measurements and disclosures under GAAP, the Partnership discloses the fair value of its investments in a hierarchy which prioritizes and ranks the level of market price observability used in measuring assets or liabilities at fair value. Market price observability is affected by a number of factors, including the type of investment and the characteristics specific to the investment. Assets or liabilities with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of market price observability and a lesser degree of judgment used in measuring fair value.

Inputs are used in applying the various valuation techniques and broadly refer to the assumptions that market participants use to make valuation decisions, including assumptions about risk. Inputs may include price information, volatility statistics, specific and broad credit data, liquidity statistics, and other factors. In such cases, the determination of which category within the fair value hierarchy is appropriate for any given investment is based on the lowest level of input that is significant to the fair value measurement. The Partnership's assessment of the significance of particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the investment. The General Partner considers observable data to be that market data which is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market. The categorization of a financial instrument within the hierarchy is based upon the pricing transparency of the instrument and does not necessarily correspond to the General Partner's perceived risk of that instrument.

In determining an asset or liability's placement within the hierarchy, the General Partner separates the Partnership's investment portfolio into major categories as determined by the General Partner. Each of these categories can further be divided between those held long or short.

Assets or liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

Level I - Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. The type of assets or liabilities included in Level I include listed equities.

Level II - Inputs are other than quoted prices that are observable for the assets or liabilities either directly or indirectly, including inputs in markets that are not considered to be active. Certain investments and exchange traded and over-the-counter derivatives, such as forwards, and credit default swaps, are fair valued by the General Partner using observable inputs, such as quotations received from the counterparty, dealers or brokers, whenever available and considered reliable. In instances where models are used, the value of an over-the-counter derivative depends upon the contractual terms of, and specific risks inherent in, the instrument as well as the availability and reliability of observable inputs. Such inputs include market prices for reference securities, bid and ask prices yield curves, credit curves, measures of volatility, prepayment rates and correlations of such inputs. Certain exchange traded and over-the-counter derivatives,

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such as generic forwards, swaps and options, have inputs which can generally be corroborated by market data and are therefore classified within Level II. Assets or liabilities which are generally included in this category include corporate bonds and loans and credit default swaps where there is sufficient market activity for the investment, less liquid and restricted equity securities and certain exchange traded and over-the-counter derivatives.

Level III – Investments and derivative instruments classified within Level III have significant unobservable inputs, as they trade infrequently or not at all. Level III instruments include private equity investments, structured investments, certain bank loans and bridge loans, less liquid corporate debt securities (including distressed debt instruments and mezzanine), CDS Tranches, structured products (including CLOs, CDOs, and MBS). When observable prices are not available for these securities, the General Partner uses one or more valuation techniques (e.g., the market approach or the income approach) for which sufficient and reliable data is available. Within Level III, the use of the market approach generally consists of using comparable market transactions, while the use of the income approach generally consists of the net present value of estimated future cash flows, adjusted as appropriate for liquidity, credit, market and/or other risk factors.

The inputs used by the General Partner in estimating the fair value of Level III investments include the original transaction price, recent transactions in the same or similar instruments, completed or pending third-party transactions in the underlying investment or comparable issuers, subsequent rounds of financing, recapitalizations and other transactions across the capital structure, offerings in the equity or debt capital markets, and changes in financial ratios or cash flows. Certain Level III investments, such as structured investments, utilized models which rely on assumptions determined by the General Partner. Level III investments may also be adjusted to reflect illiquidity and/or non-transferability, with the amount of such discount estimated by the General Partner in the absence of market information. The fair value measurement of Level III investments does not include transaction costs that may have been capitalized as part of the security's cost basis. Assumptions used by the General Partner due to the lack of observable inputs may significantly impact the resulting fair value and therefore the Partnership's results of operations. Assets or liabilities which are generally included in this category include limited partnership interests, CDOs, privately placed debt, and privately placed equity, bonds, loans and credit default swaps for which there are no observable inputs. Those over-the-counter derivatives that have less liquidity or for which inputs are unobservable are classified within Level III. While the valuations of these less liquid over-the-counter derivatives may utilize some Level I and/or Level II inputs, they also include other unobservable inputs which are considered significant to the fair value determination. At each measurement date, the General Partner updates the Level I and Level II inputs to reflect observable inputs, though the resulting gains and losses are reflected within Level III due to the significance of the unobservable inputs.

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The following tables summarize the valuation of the Partnership's assets or liabilities by the above fair value hierarchy levels as of December 31, 2009 and 2008:

Assets at Fair Value as of December 31, 2009 (in thousands)				
	Level I	Level II	Level III	Total
Cash Equivalents	\$ 37,988	\$ -	\$ -	\$ 37,988
Investments:				
Corporate Fixed Income	-	8,280	136	8,416
Senior Bank Debt	-	24,427	7,977	32,404
Mezzanine	-	-	78,604	78,604
Preferred Stock	-	-	8,743	8,743
Purchased Options	-	-	-	-
Stock Warrants	-	-	767	767
Structured Investments	-	-	27,084	27,084
Common Stock	5,055	-	40,051	45,106
Credit Default Swaps (Assets)	-	28	-	28
Forward Contracts (Assets)	-	523	-	523
Subtotal	\$ 43,043	\$ 33,258	\$ 163,362	\$ 239,663
Liabilities at Fair Value as of December 31, 2009 (in thousands)				
	Level I	Level II	Level III	Total
Credit Default Swaps (Liabilities)	\$ -	\$ (133)	\$ (5,384)	\$ (5,517)
Forward Contracts (Liabilities)	-	(314)	-	(314)
Subtotal	\$ -	\$ (447)	\$ (5,384)	\$ (5,831)
Total	\$ 43,043	\$ 32,811	\$ 157,978	\$ 233,832

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Assets at Fair Value as of December 31, 2008 (in thousands)				
	Level I	Level II	Level III	Total
Cash Equivalents	\$ 35,327	\$ -	\$ -	\$ 35,327
Investments:				
Corporate Fixed Income	-	6,814	4,164	10,978
Senior Bank Debt	-	21,139	8,819	29,958
Mezzanine	-	-	71,259	71,259
Preferred Stock	-	-	9,503	9,503
Purchased Options	-	2,675	-	2,675
Stock Warrants	-	-	467	467
Structured Investments	-	-	16,597	16,597
Common Stock	4,418	-	37,172	41,590
Forward Contracts (Assets)	-	4,663	-	4,663
Subtotal	\$ 39,745	\$ 35,291	\$ 147,981	\$ 223,017
Liabilities at Fair Value as of December 31, 2008 (in thousands)				
	Level I	Level II	Level III	Total
Credit Default Swaps (Liabilities)	\$ -	\$ (6,298)	\$ (11,141)	\$ (17,439)
Subtotal	\$ -	\$ (6,298)	\$ (11,141)	\$ (17,439)
Total	\$ 39,745	\$ 28,993	\$ 136,840	\$ 205,578



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The following tables present changes in assets or liabilities that use Level III inputs for the years ended December 31, 2009 and 2008:

<i>(in thousands)</i>	Balance as of 12/31/2008	Net change in unrealized gains (losses)	Net realized gains (losses)	Net purchases, sales, or redemptions	Net transfers into and/or (out of) Level III	Balance as of 12/31/2009
Investments:						
Corporate Fixed Income	\$ 4,164	\$ (2,366)	\$ 96	\$ (1,893)	\$ 135	\$ 136
Senior Bank Debt	8,819	6,636	238	(11,069)	3,353	7,977
Mezzanine	71,259	5,219	(5,776)	7,902	-	78,604
Preferred Stock	9,503	(1,170)	437	(27)	-	8,743
Stock Warrants	467	300	5	(5)	-	767
Structured Investments	16,597	5,249	419	4,819	-	27,084
Common Stock	37,172	17,585	(17,639)	2,933	-	40,051
Credit Default Swaps (Liabilities)	(11,141)	5,757	(4,583)	4,583	-	(5,384)
Total	\$ 136,840	\$ 37,210	\$ (26,803)	\$ 7,243	\$ 3,488	\$ 157,978

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<i>(in thousands)</i>	Balance as of 12/31/2007	Net change in unrealized gains (losses)	Net realized gains (losses)	Net purchases, sales, or redemptions	Net transfers into and/or (out of) Level III	Balance as of 12/31/2008
Investments:						
Corporate Fixed Income	\$ 3,895	\$ (527)	\$ 1	\$ (1)	\$ 796	\$ 4,164
Senior Bank Debt	14,453	(3,736)	(138)	(1,760)		8,819
Mezzanine	113,989	1,132	3,637	(47,499)		71,259
Preferred Stock	7,911	(4,012)	-	5,576	28	9,503
Stock Warrants	664	(295)	-	98		467
Structured Investments	57,631	(42,819)	-	1,785		16,597
Common Stock	30,012	(42,292)	(2,985)	52,437		37,172
Credit Default Swaps (Liabilities)	(1,064)	(10,077)	-	-		(11,141)
Total	\$ 227,491	\$ (102,626)	\$ 515	\$ 10,636	\$ 824	\$ 136,840

All net realized and unrealized gains (losses) in the table above are reflected in the accompanying Statements of Operations. At December 31, 2009, there was a \$16,103,443 change to change in unrealized gain on investments classified as Level III as of December 31, 2009. At December 31, 2008, there was a \$116,509,630 change to change in unrealized losses on investments classified as Level III as of December 31, 2008. See Note 2 for the Partnership's valuation techniques used to measure fair value.

Effective January 1, 2009, the Partnership adopted the authoritative guidance under GAAP on determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. Accordingly, if the Partnership determines that either the volume and/or level of activity for an asset or liability has significantly decreased (from normal conditions for that asset or liability) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value. Valuation techniques such as an income approach might be appropriate to supplement or replace a market approach in those circumstances. The guidance also provides a list of factors to determine whether there has been a significant decrease in relation to normal market activity. Regardless, however, of the valuation technique and inputs used, the objective for the fair value measurement in those circumstances is unchanged from what it would be if markets were operating at normal activity levels and/or transactions were orderly; that is, to determine the current exit price.

The Partnership has also adopted the authoritative guidance under GAAP for estimating the fair value of investments in investment companies that have calculated net asset value per share in accordance with the specialized accounting guidance for Investment Companies. Accordingly, in circumstances in which net asset value per share of an investment is not determinative of fair value, the Partnership estimates the fair value of an investment in an investment company using the net asset value per share of the investment (or its equivalent) without further adjustment, if the net asset value per share of the investment is determined in accordance with the specialized accounting guidance for Investment Companies as of the reporting entity's

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measurement date. The adoption of this guidance does not have a material effect on the financial statements. There have been no significant changes in valuation techniques and related inputs used by the General Partner during the year ended December 31, 2009.

#### **5. Market and Credit Risks of Debt Securities**

The Partnership's investing activities expose it to various types of risk that are associated with the financial instruments and markets in which it invests. The significant types of financial risks to which the Partnership is exposed include, but are not limited to market risk, liquidity risk, credit risk and other additional risks. Certain aspects of those risks are addressed below.

##### **Market Risk**

Market risk encompasses the potential for both losses and gains and includes price risk, currency risk and interest rate risk. The fair value of investments and securities sold short will generally fluctuate with, among other things, changes in prevailing interest rates, general economic conditions, the condition of certain financial markets, developments or trends in any particular industry and the financial condition of the issuer. During periods of limited liquidity and higher price volatility, the Partnership's ability to dispose of investments at a price and time that the Partnership deems advantageous may be impaired.

##### **Price Risk**

The prices of securities held by the Partnership may decline in response to certain events, including those directly involving the companies whose securities are owned by the Partnership; conditions affecting the general economy; overall market changes; local, regional or global political, social or economic instability; and currency, interest rate and commodity price fluctuations.

##### **Currency Risk / Foreign Markets Risks**

The Partnership may invest in financial instruments and enter into transactions denominated in currencies other than its functional currency. Consequently, the Partnership may be exposed to risks that the exchange rate of its currency relative to other foreign currencies may change in a manner that has an adverse effect on the fair value of that portion of the Partnership's assets or liabilities denominated in currencies other than the functional currency.

The Partnership may have investments in various countries, including emerging market countries. Investments in these countries involve risks, including, but not limited to, risks relating to adverse political, social, and economic developments in other countries, as well as risks resulting from the differences between the regulations to which issuers and markets are subject in different countries. These risks may include expropriation of assets, confiscatory taxation, withholding taxes on dividends and interest paid on Partnership investments, currency exchange controls, and other limitations on the use or transfer of Partnership assets and political or social instability. Such investments may also involve currency exchange rate risks. There may be rapid changes in the value of foreign currencies or securities, causing the fair value of Partnership investments to be volatile.

##### **Interest Rate Risk**

Interest rate risk refers to the risks associated with market changes in interest rates. Interest rate changes may affect the fair value of a debt instrument indirectly and directly. In general, rising interest rates will negatively impact the price of a fixed rate debt instrument and falling interest rates will have a positive effect on price. Adjustable rate instruments also react to interest rate changes in a similar manner although generally to a lesser degree. Interest rate sensitivity is generally more pronounced and less predictable in instruments with uncertain payment or prepayment schedules.

The interest rate hedging transactions subject the Partnership to off balance-sheet risks, which include counterparty credit risk. The Partnership manages this exposure by entering into interest rate hedging transactions with internationally recognized financial institutions, which are expected to perform under the

# **Sankaty Credit Opportunities, L.P.**

## **Notes to Financial Statements**

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terms of the contracts, and evaluating the creditworthiness of the institutions by taking into account credit ratings and other factors.

#### **Liquidity Risk**

Liquidity risk is the risk that the Partnership will encounter difficulty in meeting obligations associated with financial liabilities. Among other things liquidity could be impaired by an inability to access secured and /or unsecured sources of financing.

#### **Leverage Risk**

The Partnership may use leverage directly and indirectly. The Partnership currently uses leverage indirectly mainly through credit default swaps. The use of leverage will increase the volatility of the Partnership. While the use of borrowed funds will increase returns if the Partnership earns a greater return on the incremental investments purchased with borrowed funds than it pays for such funds, the use of leverage will decrease returns if the Partnership fails to earn as much on such incremental investments as it pays for such funds. The effect of leverage may therefore result in a greater decrease in the net asset value of the Partnership than if the Partnership was not as leveraged.

#### **Financing Risk**

In the normal course of business, the Partnership enters into agreements with certain counterparties for OTC derivative transactions. These agreements contain among other conditions events of default and termination events, and various covenants and representations.

There is no guarantee that the Partnership's borrowing arrangements or other arrangements for obtaining leverage will continue to be available, or if available, will be available on terms and conditions acceptable to the Partnership. Unfavorable economic conditions also could increase funding costs, limits access to the capital markets or result in a decision by lenders not to extend credit to the Partnership. In addition, a decline in fair value of the Partnership's assets may have particular adverse consequences in instances where they have borrowed money based on the fair value of those assets. A decrease in fair value of those assets may result in the lender (including derivative counterparties) requiring the Partnership to post additional collateral or otherwise sell assets at a time when it may not be in the Partnership's best interest to do so.

#### **Illiquidity of Investments**

The Partnership may invest in securities, bank debt and other claims, and other assets, which are subject to legal or other restrictions on transfer or for which no liquid market exists. The market prices, if any, for such investments tend to be volatile and may not be readily ascertainable, and, for various reasons, the Partnership may not be able to sell them when it desires to do so or to realize what it perceives to be their fair value in the event of a sale. Restricted securities are generally fair valued at a price lower than similar securities that are not subject to restrictions on resale.

Some of the Partnership's investments may be illiquid and the Partnership may not be able to vary the portfolio in response to changes in economic and other conditions. The securities that are purchased in connection with privately negotiated transactions are not registered under the relevant securities laws, which may result in a prohibition against their transfer, sale, pledge or other disposition except in a transaction that is exempt from the relevant registration requirements. Some of the bank loans, mezzanine securities and the collateralized loan obligation investments that are purchased and sold are traded in private, unregistered transactions and are therefore may be subject to restrictions on resale or otherwise have no established trading market. In addition, if the Partnership is required to liquidate all or a portion of its portfolio quickly, the Partnership may realize significantly less than the fair value at which it previously recorded those investments. The Partnership may from time to time invest in derivative contracts traded over the counter, which are not traded in an organized public market and may be illiquid. Furthermore, the Partnership may face other restrictions in its ability to liquidate an investment in a business entity to the



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extent that the Partnership have or could be attributed with material non-public information regarding such business entity.

#### **Credit Risk**

Credit risk refers to the likelihood that an issuer will default in the payment of principal and/or interest on an instrument. Financial strength and solvency of an issuer are the primary factors influencing credit risk. In addition, subordination, lack or inadequacy of collateral or credit enhancement for a debt instrument may affect its credit risk. Credit risk may change over the life of an instrument and securities which are rated by rating agencies are often reviewed and may be subject to downgrade.

The Partnership is subject to the credit risk of its custodians, prime brokers and counterparties to the extent they may be unable to fulfill their obligations either to return the Partnership's securities or to repay amounts owed. Credit risk is measured by the loss the Partnership would record if its counter parties failed pursuant to terms of their obligations to the Partnership.

#### **Bank Loans**

The Partnership invests in loans originated by banks and other financial institutions. The loans invested in by the Partnership may include term loans and revolving loans, may pay interest at a fixed or floating rate and may be senior or subordinated and may be purchased in the form of assignments or participations in all or a portion of loans from third parties. Purchasers of bank loans are predominantly commercial banks, investment funds and investment banks. Based on activity in the bank loan market the Partnership is exposed to liquidity risk as well as the risk of the borrower.

#### **High Yield Debt**

The Partnership invests in high yield debt whose rating is typically below investment-grade by one or more nationally recognized statistical rating organizations or is unrated but of comparable credit quality to obligations rated below investment-grade, and has greater credit and liquidity risk than more highly rated debt obligations. As a result the Partnership is exposed to liquidity risk and the risk of the obligor.

#### **Structured Investments**

The Partnership invests in Structured Investments. The Structured Investments include investments in both Collateralized Debt Obligations and Collateralized Loan Obligations and are either debt or subordinated equity investments. These investments have limited secondary markets and in some instances can have restrictions on transfers. Debt investments are nonrecourse obligations; therefore, the debt is payable solely from the collateral obligations and all other assets pledged. Depending on the structure of the investment and the investment made, the Partnership's debt investments could be subordinate to other classes of debt. All equity interests are unsecured and subordinate to all classes of debt. Subordinated debt and equity investments represent leveraged investments in underlying assets.

#### **Credit Derivatives**

The Partnership invests in credit derivatives. These transactions generally provide for the transfer from one counterparty to another of certain credit risks inherent in the ownership of a financial asset such as a bank loan or a high yield debt security. Such risks include, among other things, the risk of default and insolvency of the obligor of such asset; the risk that the credit of the obligor or the underlying collateral will decline or that credit spreads for like assets will change. Credit derivatives are used to gain or reduce exposure to one or more reference assets, to reduce concentration risk, or to diversify the investment portfolio.

## **6. Transactions with Affiliates**

#### **Management Fees**

From the initial closing date of August 12, 2002 (the "Initial Closing Date") until August 12, 2006, at the beginning of each fiscal quarter, the Partnership paid the Investment Advisor a management fee at the annual rate of 1.5% of the capital commitments of the limited partners. Subsequent to August 12, 2006, the Partnership pays the Investment Advisor a management fee at the annual rate of 1.5% of partners' capital.

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## Notes to Financial Statements

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The Investment Advisor may, in its sole discretion, waive the management fee with respect to certain members of the Bain Capital Group. In that case, the base for calculating the management fee will be reduced by such persons' capital commitments or allocable portion of partners' capital, as the case may be. For the years ended December 31, 2009 and 2008, \$197,348 and \$183,960 of management fees were waived, respectively.

On January 1, 2005, the Partnership entered into an agreement with the Investment Advisor in respect of any managed Swap Transactions, as defined, whereby the Investment Advisor will furnish advice to the Partnership regarding the terms thereof and the composition of the related reference portfolio of the Swap Transactions. On the first business day of each fiscal quarter, the Partnership pays the Investment Advisor a Management Fee for advice on each Swap Transaction ("Swap Management Fee") in an amount equal to the product of the Notional Amount with respect to such Swap Transaction and an annual rate as noted below.

The Partnership held the following tranches of managed Swap Transactions at December 31, 2009.

Swap Transaction	Notional Amount	Tranche	Fee Percentage
Plum Island III	\$13.9 million	20 – 23%	0.30%
Plum Island III	\$8.3 million	16 – 19%	0.55%
Plum Island III	\$6.9 million	10 – 13%	0.70%

The Partnership held the following tranches of managed Swap Transactions at December 31, 2008.

Swap Transaction	Notional Amount	Tranche	Fee Percentage
Plum Island I	\$5 million	10 – 13%	0.70%
Plum Island I	\$15 million	15 – 18%	0.60%
Plum Island II	\$4.5 million	13 – 16%	0.65%
Plum Island III	\$13.9 million	20 – 23%	0.30%
Plum Island III	\$8.3 million	16 – 19%	0.55%
Plum Island III	\$6.9 million	10 – 13%	0.70%

During December 31, 2009 and 2008, the Partnership paid \$248,262 and \$295,014, respectively, of Swap Management Fees to the Investment Advisor which is included in professional fees and operating expenses on the Statements of Operations. There was a \$3,781 and \$7,251 payable at December 31, 2009 and 2008, respectively, which is included in accrued expenses and other liabilities on the Statements of Assets, Liabilities and Partners' Capital.

#### Collateralized Debt Obligations ("CDOs")

The Partnership has invested in the following eight CDOs (both cash flow and market value CDOs) managed by the Investment Advisor. The Partnership's investments in these CDOs are reflected in the accompanying Condensed Schedule of Investments within the Structured Investments classification. These are fair valued by the General Partner as described in Note 2.

#### Avery Point CLO, Ltd. ("Avery Point")

The Partnership has invested in Avery Point, a cash flow CDO. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in December 2003.

Avery Point's capital structure consists of \$510 million of various classes of debt, including Preference Shares. Preference Shares are unsecured and subordinated with respect to cash payments to all other debt holders. The Preference Share holders do not control the election of the directors. During the year ended December 31, 2003, the Partnership purchased a \$9,450,000 face value investment in the Preference Shares of Avery Point for \$9,331,875. As of December 31, 2009 and 2008, the Partnership's investment was fair valued at \$4,866,750 and \$3,976,560, respectively. During the year ended December 31, 2009, the

# **Sankaty Credit Opportunities, L.P.**

## **Notes to Financial Statements**

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Partnership received income distributions of \$400,875 and \$1,577,491, respectively, from its investment in Avery Point which are included in dividends and other income in the accompanying Statements of Operations. The CDO pays management fees to the Investment Advisor equal to 0.10% annually of the sum of total par of the CDO and cash. The CDO may also pay subordinated management fees equal to 0.50% annually of the sum of total par of the CDO and cash if certain criteria in the CDO are met.

#### **Chatham Light CLO, Ltd. ("Chatham Light")**

The Partnership has invested in Chatham Light, a cash flow CDO. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in December 2003.

Chatham Light's capital structure consists of \$139 million of various classes of debt, including Income Notes. Income Notes are unsecured and subordinated with respect to the cash payments to all other debt holders. The Income Note holders do not control the election of the directors. During the year ended December 31, 2004, the Partnership purchased a \$20,000,000 face value investment in the Income Notes of Chatham Light for \$20,000,000. As of December 31, 2009 and 2008, the Partnership's investment was fair valued at \$1,630,000 and \$2,270,000, respectively. During the year ended December 31, 2009, the Partnership received income distributions of \$450,896 and \$5,659,089, respectively, from its investment in Chatham Light which are included in dividends and other income in the accompanying Statements of Operations. The CDO pays management fees to the Investment Advisor equal to 0.25% annually of the sum of total par of the CDO and eligible investments. The CDO may also pay subordinated management fees equal to 0.50% annually of the sum of total par of the CDO and eligible investments if certain criteria in the CDO are met.

#### **Chatham Light CLO II, Ltd. ("Chatham Light II")**

The Partnership has invested in Chatham Light II, a cash flow CDO. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in August 2006.

Chatham Light's capital structure consists of \$536 million of various classes of debt, including Income Notes. Income Notes are unsecured and subordinated with respect to the cash payments to all other debt holders. The Income Note holders do not control the election of the directors. During the year ended December 31, 2007, the Partnership purchased a \$11,000,000 face value investment in the Income Notes of Chatham Light for \$11,000,000. As of December 31, 2009 and 2008, the Partnership's investment was fair valued at \$7,813,300 and \$3,190,000, respectively. During the year ended December 31, 2009, the Partnership received income distributions of \$345,944 and \$3,090,446, respectively, from its investment in Chatham Light II which are included in dividends and other income in the accompanying Statements of Operations. The CDO pays management fees to the Investment Advisor equal to 0.25% annually of the sum of total par of the CDO and cash. The CDO may also pay subordinated management fees equal to 0.50% annually of the sum of total par of the CDO and cash if certain criteria in the CDO are met.

During the year ended December 31, 2009, the Partnership purchased a \$260,000 face value investment in the Class C Notes of Chatham Light II for \$22,100. As of December 31, 2009, the Partnership's investment was fair valued at \$156,000. During the year ended December 31, 2009, the Partnership earned interest income of \$4,060 from its investment in Chatham Light II Class C Notes which is included in interest income in the accompanying Statements of Operations. The interest receivable at December 31, 2009 is \$844, which is included in Interest receivable in the Statements of Assets, Liabilities and Partners' Capital.

During the year ended December 31, 2009, the Partnership purchased a \$1,087,603 face value investment in the Class D Notes of Chatham Light II for \$549,348. As of December 31, 2009, the Partnership's investment was fair valued at \$652,562. During the year ended December 31, 2009, the Partnership earned interest income of \$13,640 from its investment in Chatham Light II Class C Notes which is included in interest income in the accompanying Statements of Operations. The interest receivable at December 31, 2009 is \$8,521, which is included in Interest receivable in the Statements of Assets, Liabilities and



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#### **Partners' Capital.**

##### **Race Point CLO, Ltd. ("Race Point")**

The Partnership has invested in Race Point, a cash flow CDO. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in November 2001.

Race Point's capital structure consists of \$503 million of various classes of debt, including Subordinated Interest. Subordinated Interest is unsecured and subordinated with respect to cash payments to all other debt holders. The Subordinated Interest holders do not control the election of the directors. At December 31, 2009 and 2008, the Partnership's investment of \$5,000,000 face value in Race Point Subordinated Interest was fair valued at \$1,531,500 and \$2,138,000, respectively. During the year ended December 31, 2009, the Partnership received distributions of \$185,812 and \$728,838, respectively, from its investment in Race Point. Included in the 2009 and 2008 distribution is \$185,812 and \$728,838, respectively, which represents a return of the Partnership's investment in Race Point. The CDO pays management fees to the Investment Advisor equal to 0.275% annually of the sum of total par of the CDO and cash. The CDO may also pay subordinated management fees equal to 0.25% annually of the sum of total par of the CDO and cash if certain criteria in the CDO are met.

##### **Race Point II CLO, Ltd. ("Race Point II")**

The Partnership has invested in Race Point II, a cash flow CDO. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in April 2003.

Race Point II's capital structure consists of \$550 million of various classes of debt, including Subordinated Interest. Subordinated Interest is unsecured and subordinated with respect to cash payments to all other debt holders. The Subordinated Interest holders do not control the election of the directors. During the year ended December 31, 2003, the Partnership purchased a \$10,180,000 face value investment in the Subordinated Interest of Race Point II for \$9,671,000. At December 31, 2009 and 2008, the Partnership's investment was fair valued at \$5,018,740 and \$5,022,812, respectively. During the year ended December 31, 2009 and 2008, the Partnership received distributions of \$671,598 and \$2,040,232, respectively, from its investment in Race Point II. Included in the 2009 distribution is \$461,622, which represents a return of the Partnership's investment in Race Point. The CDO pays management fees to the Investment Advisor equal to 0.10% annually of the sum of total par of the CDO and cash. The CDO may also pay subordinated management fees equal to 0.50% annually of the sum of total par of the CDO and cash if certain criteria in the CDO are met.

##### **Rose Island, LLC ("Rose Island")**

The Partnership has invested in Rose Island, a Delaware LLC. Rose Island was formed by the Partnership and other affiliated entities for the sole purpose of making a loan in the principal amount of \$25,969,501 to a third party entity for the purpose of providing a portion of the proceeds for the acquisition of certain loans issued by investment funds managed by Sankaty Advisors, LLC. Rose Island consists only of the membership interests of the Partnership and affiliated entities of \$25,969,501.

During the year ended December 31, 2009, the Partnership purchased a \$4,550,586 membership interest in Rose Island at par. During the year ended December 31, 2009, the Partnership received \$3,208,506 to pay down the principal balance of the investment in Rose Island. As of December 31, 2009, the Partnership's investment was fair valued at \$1,330,556. During the year ended December 31, 2009, the Partnership earned interest income of \$5,839, which is included in interest income in the accompanying Statements of Operations. The interest receivable at December 31, 2009 is \$458, which is included in Interest receivable in the Statements of Assets, Liabilities and Partners' Capital.



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#### **Sankaty High Yield Partners II, L.P. ("Sankaty II")**

The Partnership has invested in Sankaty II, a market value CDO. This entity was established for the purpose of acquiring and managing a diverse portfolio of primarily below investment-grade assets consisting of senior bank debt, corporate fixed income securities, structured debt instruments, limited partnerships, mezzanine investments, equity securities and certain other investments.

Sankaty II's capital structure consists of \$214 million of debt and \$179 million of limited partnership interests. During the year ended December 31, 2003, the Partnership purchased a 5.4% limited partnership interest in Sankaty II for \$4,836,940. As of December 31, 2009 and 2008, the Partnership's investment was fair valued at \$0. During the years ended December 31, 2009 and 2008, the Partnership received distributions of \$0, from its limited partnership interest in Sankaty II. During each of the years ended December 31, 2009 and 2008, the Partnership was charged \$0 and \$541,044 in Sankaty II management fees, respectively. During the years ended December 31, 2009 and 2008, carried interest of \$0 and \$65,444, respectively, was returned to the Partnership.

During the year ended December 31, 2005, the Partnership purchased, at par, \$3.85 million of Class E Junior Subordinated Secured Notes of Sankaty II. As of December 31, 2009 and 2008, the Partnership's investment was fair valued at \$0. During the years ended December 31, 2009 and 2008, the Partnership earned interest income of \$0 and \$367,155, respectively, from its investment in Sankaty II Class E Notes which is included in interest income in the accompanying Statements of Operations. The interest receivable at December 31, 2009 and 2008 is \$0, which is included in Interest receivable in the Statements of Assets, Liabilities and Partners' Capital. Sankaty II is currently in default and has stopped making interest payments. For the years ended December 31, 2009 and 2008, interest of \$334,529 and \$93,372, respectively, has been included as paid in kind and is included in the principal balance of the investment.

During the year ended December 31, 2009, the Partnership purchased, \$5.05 million Par of Class C Fixed Notes of Sankaty II for \$3.13 million. As of December 31, 2009, the Partnership's investment was fair valued at \$3.68 million. During the year ended December 31, 2009, the Partnership earned interest income of \$70,513 from its investment in Sankaty II Class C Fixed Notes which is included in interest income in the accompanying Statements of Operations. The interest receivable at December 31, 2009 is \$30,804, which is included in Interest receivable in the Statements of Assets, Liabilities and Partners' Capital. Sankaty II is currently in default and has stopped making interest payments. Interest earned but not paid of \$39,710 has been included as paid in kind and is included in the principal balance of the investment.

During the year ended December 31, 2009, the Partnership purchased \$382,173 of Class A-2 Notes for \$382,173. As of December 31, 2009, the Partnership's investment was fair valued at \$382,173.

#### **Sankaty High Yield Partners III, L.P. ("Sankaty III")**

The Partnership has invested in Sankaty III, a market value CDO. This entity was established for the purpose of acquiring and managing a diverse portfolio of primarily below investment-grade assets consisting of senior bank debt, corporate fixed income securities, structured debt instruments, limited partnerships, mezzanine investments, equity securities and certain other investments.

Sankaty III's capital structure consists of \$141 million of debt and \$119 million of limited partnership interests. During the year ended December 31, 2006, the Partnership purchased, at par, \$260,000 of Class E Junior Subordinated Secured Notes of Sankaty III. As of December 31, 2009 and 2008, the Partnership's investment was fair valued at \$0. During the years ended December 31, 2009 and 2008, the Partnership earned interest totaling \$0 and \$21,461, respectively, from its investment in Sankaty III which is included in interest income in the Statements of Operations. The interest receivable at December 31, 2009 and 2008 is \$0. Sankaty III is currently in default and has stopped making interest payments. For the years ended December 31, 2009 and 2008, interest of \$23,927 and \$6,511, respectively, has been included as paid in kind and is included in the principal balance of the investment.

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#### **Bain Capital Investments**

Certain other investments included in the accompanying Condensed Schedule of Investments have been issued by organizations in which investment funds advised by a related party have made substantial equity investments and may control the organization. At December 31, 2009 and 2008, the aggregate fair value of these securities was \$65,597,582 and \$36,145,544, respectively.

From time to time the Partnership may sell investments to other entities advised by the Investment Advisor. All such cross trades are executed at a price provided by a third party, where available. If no third party price is available the Investment Advisor will purchase or sell the asset to a third party to determine a price or utilize another third party price source approved by the Investment Advisor Compliance Group. All such cross trades are reviewed by the Investment Advisor Compliance Group. During the year ended December 31, 2009, the Partnership sold investments for proceeds of \$2,091,768 to other entities advised by the Investment Advisor or its affiliates at fair value resulting in net realized loss of \$45,363. During the year ended December 31, 2008, there were no investments sold to other entities advised by the Investment Advisors or its affiliates.

#### **Other Expenses and Payables**

During the years ended December 31, 2009 and 2008, \$466,250 and \$488,470, respectively, of the Partnership's expenses were paid by a related party of the General Partner, which were reimbursed by the Partnership. As of December 31, 2009 and 2008, there was no outstanding payable for these expenses.

### **7. Commitments**

Certain of the Partnership's investments in revolving bank loans included unfunded commitments. As of December 31, 2009 and 2008, unfunded commitments totaled \$108,709 and \$387,555, respectively.

In the normal course of business, the Partnership enters into contracts that contain a variety of representations and warranties and which provide general indemnifications. The Partnership's maximum exposure under these is unknown, as this would involve future claims that may be made against the Partnership that have not yet occurred. However, based on experience, the General Partner expects the risk of loss to be remote.

### **8. Partners' Capital and Allocations**

Prior to the eighth anniversary of the Initial Closing Date, the aggregate capital commitments of all partners shall not exceed \$500 million. The General Partner is required to maintain a capital commitment balance of at least 1% of the aggregate capital commitments of all partners.

Limited Partners may not voluntarily withdraw all or any portion of their Book Capital Accounts until August 12, 2010 without the consent of the General Partner. The General Partner may not withdraw any portion of its Book Capital Account prior to August 12, 2010. The General Partner may at its sole discretion at any time and for any reason require a limited partner to withdraw all or any portion of its Basic Capital Account.

#### **Income, Expense, and Carried Interest Allocations**

The realized and unrealized investment profits and losses of the Partnership will initially be apportioned among the partners based on their Basic Capital Accounts as of the first day of the fiscal quarter. The portion of the realized and unrealized investment profits and losses is then first allocated to each limited partner until it reaches a Total Return reflecting an 8% annualized rate of return on its net capital contributions. Next, the investment profits and losses are allocated to the General Partner as carried interest until the cumulative amount equals 20% of the net profits allocated to all partners in the current and all prior fiscal quarters. Lastly, 80% is allocated to the limited partners and 20% is allocated to the General Partner. As of the last business day of each fiscal period in which net loss was initially apportioned to the Limited Partners, such net loss will then be allocated between each Limited Partners and the General

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Partner so as to reverse any net profits allocated as provided above. There was \$10,748,732 of carried interest allocated during the year ended December 31, 2009 and \$9,930,556 of carried interest clawback allocated during the year ended December 31, 2008. The General Partner may waive all or any part of the carried interest that it would otherwise be entitled to receive from partners who are members of the Bain Capital Group. For the years ended December 31, 2009 and 2008, \$17,630 and \$103,282 of carried interest was waived, respectively. From the Initial Closing Date until August 12, 2006, the management fee was allocated to the limited partners based on capital commitment balances as of the first day of the fiscal quarter. Thereafter, it has been allocated based on limited partners' Book Capital Accounts as of the first day of the fiscal quarter. Miscellaneous income and expenses are allocated based on each partner's Book Capital Account as of the first day of the fiscal quarter.

#### **New Issues**

Realized and unrealized profits and losses on certain securities involving initial public offerings are allocated only to those partners that are not considered restricted persons as defined by the Financial Industry Regulatory Authority Inc. ("FINRA"). The restricted partners are allowed New Issue gains and losses at the same percentage as their beneficial ownership unless the combined beneficial ownership of these partners exceeds 10%, in which case only 10% of the New Issue gains and losses will be allocated. The remaining New Issue gains and losses are allocated to those partners who do participate in New Issues. The accounts of those partners who do not participate in New Issues are credited with interest on their proportionate share of the funds utilized to purchase New Issues. During the years ended December 31, 2009 and 2008, there were no net profits from New Issues.

#### **Profits and Losses of Designated Investments**

Profits and losses relating to certain illiquid securities designated as such by the General Partner ("Designated Investments") are allocated to partners at the end of each fiscal quarter in proportion to the partners' respective share of each Designated Investment. Partners' respective share of the Designated Investment is based on their Basic Capital Accounts as of the beginning of the fiscal quarter in which the Designated Investment was originally acquired. There were \$13,070,380 and \$13,407,372 of Designated Investments held at December 31, 2009 and 2008, respectively, with a cost basis of \$48,720,217 and \$49,367,651, respectively.

#### **Distributions**

Distributions are made at the sole discretion of the General Partner. Generally, cash distributions representing profits are made in the same proportion as such profit is allocated to the capital accounts. Cash distributions representing returns of capital are made in proportion to the partners' Basic Capital Accounts (as defined in the Partnership Agreement). Distributions of publicly traded securities are fair valued at the last trade price or, if unavailable, at the last bid price on the date of distribution.

#### **9. Lehman Brothers Holdings, Inc.**

During the year ended December 31, 2008, Lehman Brothers Holdings, Inc. ("LBHI") and certain of its affiliates sought protection under the insolvency laws of their jurisdictions of organization, including the United States, the United Kingdom and Japan. The Partnership had entered into swap transactions, securities trades and other transactions with LBHI and its affiliates. At the date of the bankruptcy filing, the Partnership had outstanding swap transactions with Lehman Brothers Special Financing ("LBSF"), an affiliate of LBHI, for which LBHI served as credit support provider. The Partnership had posted collateral amounts in accordance with the swap transactions. As a result of the bankruptcy filing, the Partnership terminated its trades and related agreements with LBSF and has initiated claims for damages. LBSF and LBHI may be unable to fulfill their commitments under the agreements, however the General Partner believes that the financial impact to the Partnership relating to these events is immaterial.

#### **10. Other Required Disclosure**

For the year ended December 31, 2009, excluding the allocation of carried interest, the ratio of net

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**December 31, 2009 and 2008**

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investment income to average limited partners' capital was 5.08%, the ratio of expenses to average limited partners' capital before and after carried interest was 1.96% and 5.99%, respectively, and the limited partners' total return before and after carried interest was 21.82% and 17.10%, respectively. For the year ended December 31, 2008, excluding the allocation of carried interest, the ratio of net investment income to average limited partners' capital was 8.90%, the ratio of expenses to average limited partners' capital before and after carried interest was 1.74% and -1.14%, respectively, and the limited partners' total return before and after carried interest was -25.18% and -22.42%, respectively.

**11. Subsequent Events**

Management has evaluated the events and transactions that have occurred through March 26, 2010, the date the financial statements were issued, and subsequent to year end, the Partnership has made a cash distribution of \$25,000,000.